Corporate Pension Reform in Japan
Outline of the "Defined Benefit Corporate Pension Bill" and its impact

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1. Introduction

The Defined Benefit Corporate Pension Bill (hereinafter, "DB Pension Bill"), which was based on two years of discussion by the government, was submitted to the Diet on 20 February 2001. One major purpose of the act is the protection of employee benefit rights. In this respect, the act provides (1) funding requirements, (2) fiduciary responsibility, and (3) reporting and disclosure.

There have been major concerns within the business world about the treatment of subcontracted parts of Employees Pension Funds (EPF), because they have placed a big burden on plan sponsors since the stock market plunged in February 1990. In order to reflect these public interests, the bill also prescribes requirements on transferring the obligations and rights of EPF into other types of qualified pension plans.

The DB Pension Bill also states plan design requirements to get tax qualification.

In this paper, I briefly view the outline of corporate pension plans in Japan, and then discuss their issues. Secondly there is an explanation of the DB Pension Bill. Finally, I discuss its impacts on plan sponsors and participants.

2. Overview of Japanese corporate pension plans in the 20th century

(1) Retirement Allowance Plan (RAP)

Most Japanese employers have retirement allowance plans providing lump sum benefits in the event of termination of employment, whether voluntary (such as resignation) or involuntary (such as dismissal or death or reaching the normal retirement age). Many big companies have converted a part or all of their retirement allowance plans into corporate pension plans.

Retirement allowance plan benefits are usually expressed as a scheduled multiple of final monthly pensionable pay, with the multiple varying with the length of service. Multiples differ depending on whether the employee leaves voluntarily or involuntarily, with the multiple for voluntary termination being smaller. Typically, the multiples converge after 25 to 30 years of service.

The characteristic of retirement allowance plan benefits is the termination benefit rather than the retirement benefit. The lump sum benefits in many plans are calculated without regard to age at actual resignation, reflecting this characteristic. Some argue that the benefit curve typically appears to be significantly “back-loading” compared with North American DB plans. However, if we adjust the difference of timing of payment, the Japanese plans have a somewhat “front-loading” benefit formula, even when compared with North American DB plans.

Employers with retirement allowance plans can utilize book reserve financing. For tax purposes[ii], the employer may not establish a book reserve in excess of 27%[iii] of the total sum that would be payable if all employees were to voluntarily resign their jobs.

(2) Tax Qualified Pension Plan (TQPP)

Tax Qualified Pension Plans (TQPP), which were introduced by the tax reform in 1962, are often used by Japanese employers as a funding vehicle of their RAP to achieve maximum cost and tax efficiency.

In order for a pension plan to be a TQPP, it must meet the following requirements, which are prescribed in the Corporation Tax Code and regulations.

- The plan must be funded with investment organizations such as life insurance companies, trust banks or asset management companies.
- The plan must be designed so that benefits can be paid in annuity form.
- Actuarial valuation of the plan that includes reviews of actuarial assumptions should be conducted at least once every five years with appropriate actuarial assumptions and methods.
- Actuarial liabilities should be evaluated every year.
- Plan assets shall not be refundable to employers, unless the amount of plan assets exceeds the accrued liability.

TQPPs provide annuities, usually nominally actuarially equivalent to the lump sum, but the Japanese tax system so favors lump sum retirement benefits that most retiring employees take the lump sum.

In the case that employers use a TQPP in combination with an RAP, the benefits from the RAP are typically offset by those from the TQPP. In order to achieve maximum tax efficiency, TQPPs often provide benefits only for employees who retire at normal retirement age or after another specified age.

(3) Employees Pension Fund (EPF)

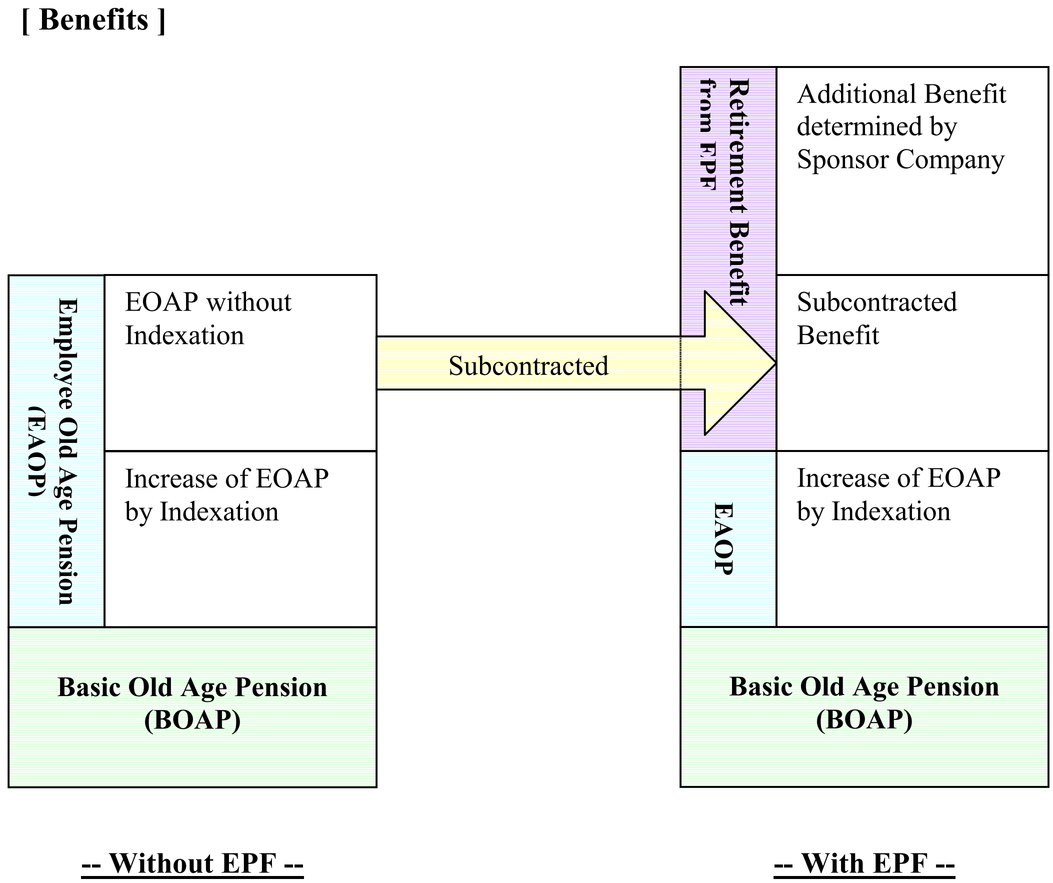
In 1966, the Employees Pension Fund (EPF) system was established to provide ample financial security to retired employees in the private sector. The system has a two-layer structure, namely, on the foundation of the national-run Employees Pension Insurance (EPI), additional benefits contributed by a company are added.

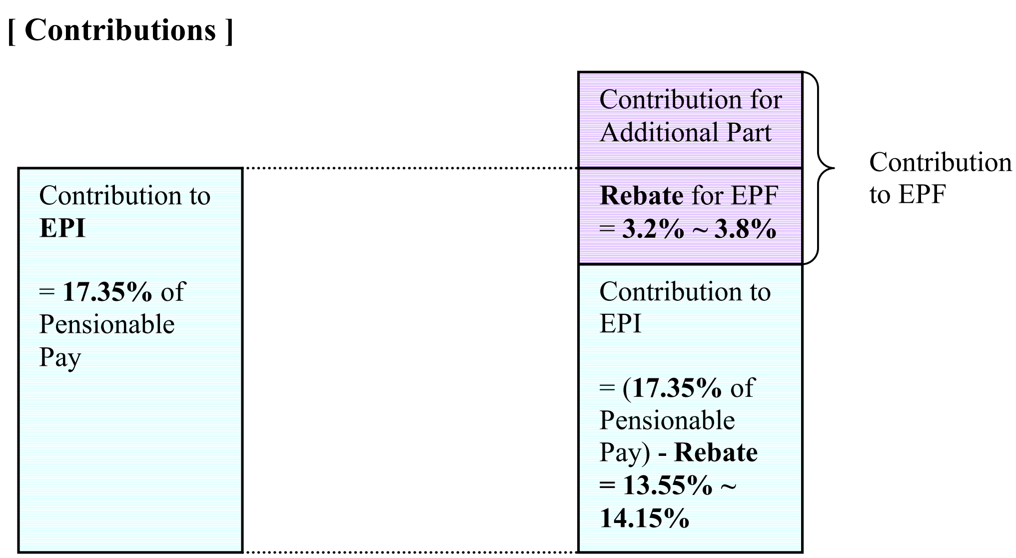
An EPF, which is a non-profit and independent legal entity that a plan-sponsor establishes to serve the participants’ interest, subcontracts a portion of the old age pensions of the EPI. In return, the plan-sponsor company of the EPF is exempt from a portion of the EPI contributions payable to the Government to compensate for the costs of providing its subcontracting benefits (see the chart on the next page).

In order for a company to establish an EPF, they must obtain approval from the Minister of Health, Labor and Welfare. The requirements for approval are as follows.

- The company must have at least 500 regular employees.[iv]
- The plan must be funded by an investment organization such as a trust bank, a life insurance company or an asset management company.
- Actuarial valuation of the plan that includes reviews of actuarial assumptions should be conducted at least once every five years with appropriate actuarial assumptions and methods.
- The plan must be structured so that benefits, or at least a portion of benefits, can be paid in life annuity form.

Chart 1: Structure of Employees Pension Fund System





- The plan must follow the minimum funding standard.
- The plan must file an annual report to the government with a certificate of an enrolled certified pension actuary for the actuarial report. The actuarial reports contain the information about the actuarial liabilities and the minimum funding standards

The rebate for an EPF is determined based on the normal cost for the subcontracted part with prescribed assumptions and actuarial cost method.

3. Public concerns about Japanese corporate pension plans

(1) Low security on RAP

Reserve funds for RAPs do not fully function as an income security system because these funds are held without actually being segregated from other company's assets. In the event of a company going bankrupt, benefits from the RAP have not been fully paid in many cases. The Law Concerning Payment and Security of Wages and Others prescribes that employers have to provide measures to ensure the reimbursement of employees' deposits and payment of RAP in case of bankruptcy. However, this is not a mandatory provision but only a regulation to encourage companies to do so.

(2) Insufficient protection of participants' rights

TQPP is a funding vehicle of an unfunded RAP and provides an income security system in case of bankruptcy. However, because of their recent low investment performance, many TQPPs have been terminated with significant unfunded liabilities. The reason for this is that there have not been any measures to secure a sufficient funding level in TQPP regulations.

For example, we assume that a company elected the amortization rate of 10% per annum of the unfunded liabilities at every valuation date. The unfunded liabilities should be revalued every year. Assuming that the unfunded liabilities of the company's plan were equal to 20% of the plan assets and that the plan assets developed an actuarial loss equal to 3% of the assets, the amount of the unfunded liabilities decrease 10% by the amortization, but increase 15% by the new actuarial loss. The regulations for TQPP allow such an amortization schedule as unfunded liabilities might increase every year under certain circumstances, even ignoring interest components.

(3) Subcontracted part of EPF

Before 1990, EPFs earned 8% to 10% on their assets every year. The rebates for subcontracted parts of EPFs were calculated using an assumed discount rate of 5.5%. This means that subcontracted parts of EPFs developed great amounts of asset gains before 1990. Since the stock market plunged in 1990, the subcontracted parts have been sources of significant asset loss in turn. Economic organizations have been insisting on a return of the obligations of subcontracted parts of EPFs to the government for the past five years.

To add fuel to the flames, new accounting standards for retirement benefits plans, which were effected from the fiscal year starting 1 April 2000, require companies to disclose the unfunded liabilities of the plans including the subcontracted part of EPF.

4. The Defined Benefit Pension Bill

(1) Purpose

The documents describing the reasons for the proposal of the DB Pension Bill say that the purposes of the act are to establish the minimum standards for DB pension plans in order to protect employees' rights on DB pension plans and in order for the DB plans to provide ample financial security to retired employees.

(2) Scope

The DB Pension Bill covers only funding plans and does not cover any book reserved plans. The security issues of RAP cannot be solved by the new act.

(3) Protection of employees' rights

There were arguments that the DB Pension Bill should contain provisions to protect employees' rights like ERISA, which does not permit employers to forfeit employees' rights on vested benefits. However, many existing pension plans have provisions to decrease the amount of benefits or not to pay the whole benefit in the case of disciplinary action. This makes it difficult to define the vested benefits as unforfeitable rights.

Instead, the DB Pension Bill sets a minimum funding standard in order to protect employees' rights. The concept is that, if a plan has enough assets to pay the benefits in the event of plan termination, we can say that employees' rights are secured. In order to strengthen the concept, the government shall continue to discuss about an organization that guarantees pension payment in the event of plan termination with unfunded liabilities. Although the detailed mechanisms are not mentioned in the act, the same requirements as ones for EPF will be applied for all the DB pension plans. The current requirements for EPF are as follows.

- The minimum secured benefits, which are very similar to the vested benefits in ERISA, shall be prescribed in the plan provisions.
- The minimum funding standard is equal to the total present value of the minimum secured benefits, using the discount rate assumptions based on the settlement rate by the Pension Fund Association and the valid EPF mortality table. The withdrawal rate assumptions and the salary increase assumptions should not be used.
- In the case that the assets fall short of the minimum funding standard, the plan sponsor must make a restoring schedule of the plan assets, such as an increase in contribution rates or acceleration of amortization.

Moreover, the fiduciary responsibilities are defined by the new act in this respect. The disclosure requirements are also introduced to all the DB pension plans, which could contribute to the protection of employees' rights.

(4) Requirements for tax qualification

As mentioned above, companies intend to provide benefits through TQPP only for employees who reach normal retirement age or an otherwise specified age, and book reserved RAPs cover the rest of the benefits. This leads to a significant lack of security for the bigger portion of employees' benefits after employment. To avoid this, the new act requires that qualified plans should provide lump-sum benefits for employees with three or more years of service and annuities for those with twenty or more years of service. The existing regulations for EPFs have the same requirements.

(5) Rule of transferring obligations and rights of a plan to another plan

The DB Pension Bill introduces rules for transferring obligations and rights of one plan to another plan. This covers public concerns about subcontracted parts of EPFs, because the rules enable the company to transfer obligations for subcontracted parts of EPFs to the government.

5. Impact of the DB Bill

(1) Move to plans without a subcontracted part

Some big companies have already declared they will return the obligation for the subcontracted part of their EPFs to the government even though the DB Pension Bill has just been referred to the Diet. It is thought that many big companies might transfer their EPF into the plans without subcontracted parts. Some argue that the movement of the obligation will have a great impact on the stock market because the assets will also be refunded to the government, even though the Bill will allow refunding by means other than cash provided that it is an index fund.

Companies that intend to return the obligations for the subcontracted part of their EPFs should note that transferring the obligations might cost a great deal, since it will require complete record matching of all the participants between EPF and the government.

(2) Shift to DC plans

The new act will set several requirements that might place extra burdens on the plan sponsors, such as funding requirements or disclosure requirements. In order to avoid such cost increases, a number of companies might move to DC plans, even though the proposed DC Bill does not allow any withdrawals before normal retirement age for any reason. The reason is that the DC Bill, which has also been discussed in the Diet, will allow converting a DB plan into a DC plan with past service. This means that an employer can wind up their DB plan and distribute the plan assets to each participant's account of the DC plan.

(3) Increase of contributions

Compared with the current TQPP requirements, the new funding requirements need higher contributions for companies, since they might apply more restrict amortization schedule. For accounting purposes, their pension costs are already measured by a common standard, so the new act does not affect companies' financial status on a stock basis. However, the increase of contributions will have an impact on their activities on a cash flow basis.

(4) Increase of administration costs

Compared with the current TQPP requirements, the new requirements entail higher administration costs for companies. The new minimum funding standards will need additional actuarial costs. TQPP regulations have not required any formal documentation or disclosure. Companies will have to pay more administration costs because of the new disclosure requirements.

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[ii] Actuaries are not involved in the valuations for tax purposes.

[iii] This is applicable for the fiscal year beginning April 1, 2001 and ending March 31, 2002, and will decrease to 23% for the next fiscal year and to 20% for the fiscal year after that.

[iv] Multi-employers plans must have at least 3,000 active participants.